No sign of development bubble, only pockets of trouble

Fast pace of construction in some markets will outstrip demand in the short run

By Alan Plush, MAI

With the effects of the Great Recession slowly fading and with a seemingly endless amount of low-cost financing available, development of independent living, assisted living and memory care seniors housing is approaching historical highs. But how much development is too much, and how will current construction impact the industry going forward? From my experience over the past 25 years — roughly the age of the seniors housing industry as we now know it — I peg the sector's first true construction boom as the late 1990s. During that period, many operators, some with nothing more than "two guys and a truck" for infrastructure, went public to capture access to equity. Over the last half of the 1990s, the industry was born.

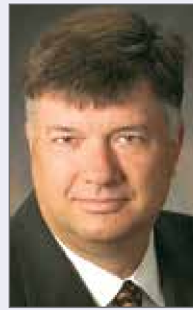
Then came the crash, when many operators and public entities ceased to exist, but the assets remained. During the ensuing years, developers added more assets and different operational and physical plant ideas were tested, to the point that the industry today has the outward appearance of being relatively homogenous.

New development these days typically follows one of several established paths, both physically and operationally. Ho hum? Insiders see a much more complex set of facts.

As a specialty appraisal firm with more than 25 years in the industry, we at HealthTrust identified leading indicators of the boom several years ago, beginning with a surge in requests for market studies on proposed projects.

What ensued was a few, then numerous, assignments for new development projects via construction lenders. As such, given our scope, we have visited many markets across the country and have formed the following broad conclusions about the current round of development:

- Most markets will get at least one new property.
- Some markets will become oversupplied.
- An increasing number of developers entering the space have little actual operational experience, turning to lenders with little seniors housing in their portfolios.
- Good operators are becoming harder and harder to find.
- It isn't as bad as it seems.



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He has indirectly or directly helped to appraise about 3,000 nursing homes, 2,500 congregate care facilities, 150 continuing care retirement centers and more than 100 hospitals.

Wide-scale overbuilding unlikely

As the table on seniors housing units under construction in the nation's top 99 metropolitan statistical areas (MSAs) shows, projects under development today will bring single-digit percentage increases in the overall supply of seniors housing units.

Obviously, an increase in supply without the context of demand growth can be futile. Looking only at assisted living (which includes memory care) at current penetration rates, our internal methodology conservatively forecasts a net increase in demand of approximately 60,000 units within the top 99 MSAs over the next five years.

Based on the indications above, space to meet about 29.5 percent of that future demand is under development. Moreover, the net demand increase equates to 17.4 percent of existing inventory, which would imply a normalized run rate of 3.5 percent annually, lower than the prevailing run rate of 5 percent or higher that we are currently seeing.

In aggregate, calling today's development activity a bubble would be an overstatement. But what remains to be seen is what demand is driving the shovels currently in the ground. Certainly, these are all broad metrics and not all MSAs are created equal, further signifying that location matters.

The original boom in seniors housing development saw the introduction of a large number of communities over a short period into markets that did not appreciate the distinction of seniors housing from a nursing, or "old folks" home.

What is starkly different with this cycle is that growth is incremental. In most markets across the United States, we see construction volume in step with the national trend shown in the table.

A typical metro area will have one or two communities under construction or that recently opened, and perhaps a third about to begin construction. In most of these markets, there are a number of potential projects in the pipeline or planning phase of development.

Pent-up demand exists due to the lack of new development during the Great Recession. Lenders and operators are more judicious in their underwriting and investing in deals than during the last cycle. Thus, many markets will fare reasonably well.

Seniors housing inventory under construction in top 99 MSAs

The number of seniors housing units under construction during the second quarter in the top 99 metropolitan statistical areas (MSAs) shows significantly more activity in the assisted living sector than in the independent living segment.

	Independent living units	% of existing units	Assisted living units	% of existing units	Nursing care beds	% of existing units
Primary markets	6,443	2.00%	10,530	5.09%	3,140	0.55%
Secondary markets	2,763	1.72%	7,177	5.83%	3,690	1.19%
Total	9,206	1.91%	17,707	5.37%	6,830	0.77%

Source: NIC MAP

Base case and doomsday scenarios

Moderate risks that are evident include "market velocity," which is a phrase we coined to describe the impact of multiple communities coming on line over a short period of time in markets that otherwise had the demographics to support them all. The resultant extended absorption period was more a function of too many properties completed at the same time, as opposed to more units or beds than the market could support.

Regardless of supply and demand, the logistics of the move-in process dictates that at any given time only so many residents are capable of relocation. While models can demonstrate adequate demand for the supply that is coming on line, timing matters as absorption can lag, staff positions become hard to fill, and financial performance will suffer.

As is the case in all real estate asset classes, existing supply that is old, hasn't been well maintained, wasn't purpose built, or is poorly located will suffer the most, with new supply exerting

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downward pressure on rent and occupancy rates.

Throughout the United States, there are locations that are under-served due to barriers to entry — typically available land — yet show high demand.

But many other second-tier locations, for lack of a better use, are now sought after as seniors housing sites. Often promoted by non-industry developers with inexperienced or thinly capitalized operator partners, these situations represent a source of pronounced risk for performance at existing and proposed projects.

Atlanta under microscope

Where we raise warning flags, however, are in markets that are experiencing hyper development activity. Having the entire country to pick from, we chose the Atlanta MSA as an example.

In Atlanta, the number of units under construction is significant (686 units, according to NIC MAP) but doesn't suggest outright instability. The proposed pipeline is nothing short of massive.

The NIC MAP McGraw Hill data cites 6,496 units in pre-planning and planning stages. Should these projects all come to fruition, the impact would be a near-term disaster for both existing and proposed seniors housing communities.

Construction bubble watch in Atlanta

The metro Atlanta market would be flooded with a new supply of seniors housing units if all the proposed projects were to be completed. That's particularly true in the assisted living segment.

	Existing	Under construction	% of existing	Proposed	% of existing
Independent living units	7,032	0	0%	1,385	19.70%
Assisted living units	8,554	686	8.02%	4,347	50.82%
Nursing care beds	13,673	0	0%	764	5.59%

Source: NIC MAP, McGraw Hill Cos.

The resulting crisis would take years to unwind. While we know that this worst-case scenario will not come to pass, it illustrates what could happen if unchecked development continues.

Five key points to success

Some 25 years into the growth of modern seniors housing, the industry has learned several secrets to success. Here are the key points to remember:

1 Seniors housing remains largely local in nature. While large concentrations of assets have occurred via REIT consolidation and operator consolidation, property operations remain very much on an asset-by-asset basis.

2 Supply/demand analytics have improved to the point that simply having a good site isn't enough to justify development anymore. The criteria for breaking ground on a project is much more complex than ever before, starting with the site and market. Savvy classes of lenders and equity investors have emerged.

3 Exhaustive work by several organizations has helped make the industry less opaque and more transparent, paving the way for accurate underwriting as well as more sensible valuations. The organizations include the National Investment Center for the Seniors Housing and Care Industry, American Seniors Housing Association and Assisted Living Federation of America.

4 Institutional investors have grown familiar with the industry, thanks to the large cap REITs and large cap operators, and that has greatly enhanced funding for existing and new inventory of seniors housing assets across the board.

5 Success in seniors housing hinges on the operator. It is worth paying a premium for operators that make liberal use of technology, are highly professional in nature, attract the best staff, and run their operations in a manner that makes them both successful and easy to understand to institutional investors.

Clearly, there will be mistakes. Some markets will become overbuilt and assets and investors will suffer as a result. Will these mistakes rise to the level of the first boom? Our opinion is "no."

The seniors housing industry is maturing and many checks and balances exist that were missing during prior cycles. The result will be continued growth in a sector that is benefitting from strong consumer demand. ■

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